DOW THEORY LETTERS INC.

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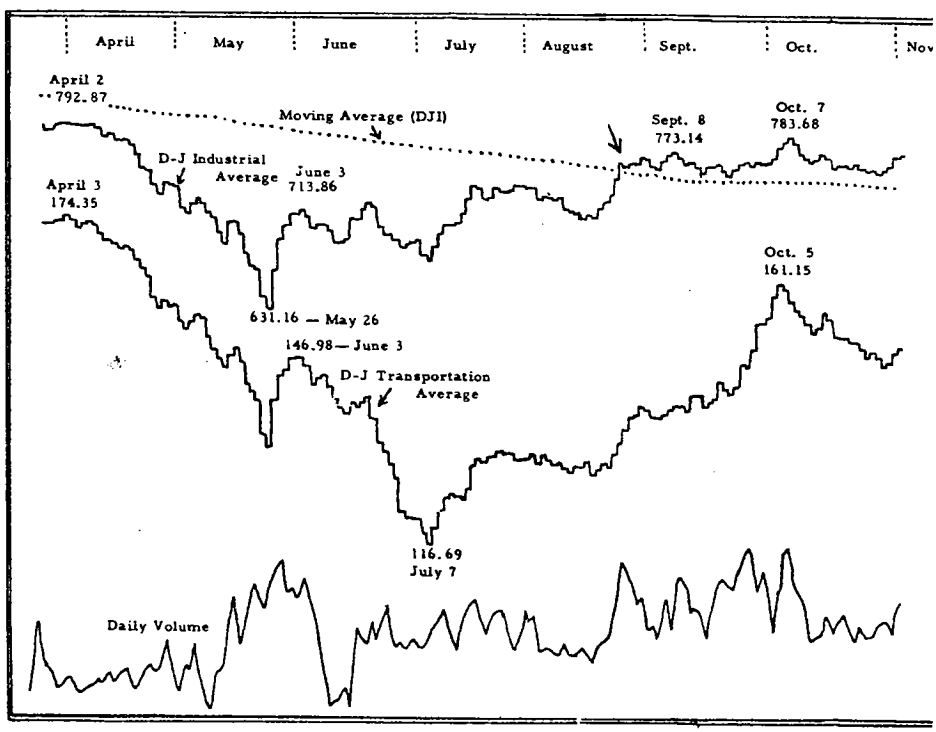
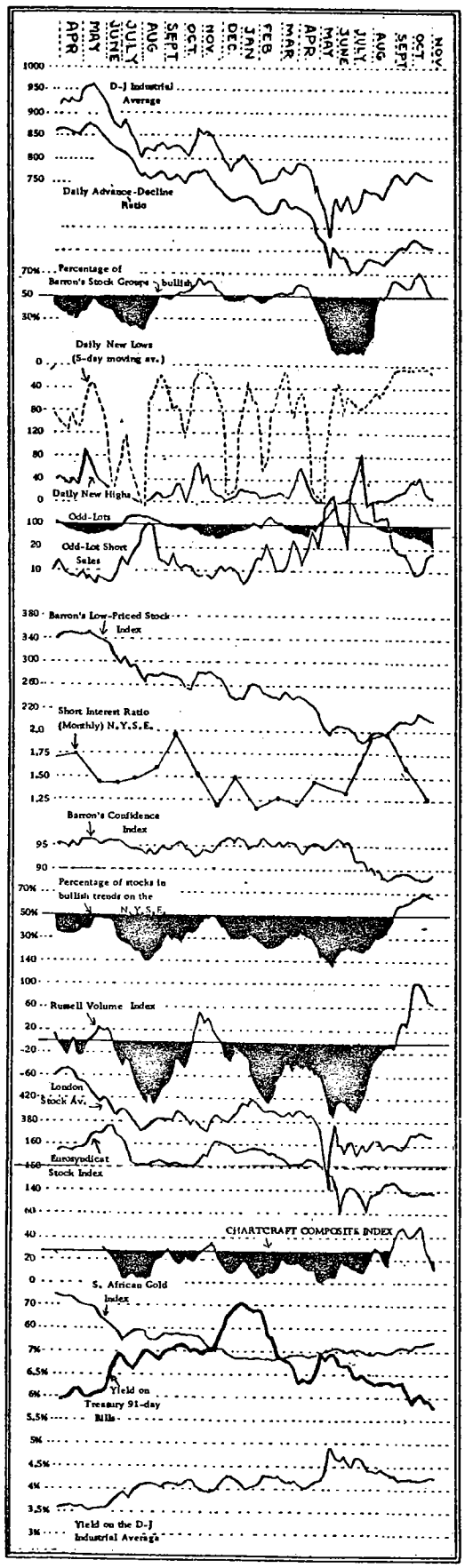
THE MARKET: The stock market seldom has had so many imponderables to contend with. For instance, a few weeks ago the Deputy Budget Director announced that the next Federal budget will rise $25 to $30 billion above the $205-210 current budget estimate if present programs merely continue in effect. The Director estimated that 70% of the rise would be in "uncontrollable" items such as interest on the growing debt, Social Security and welfare benefits, etc.

Meanwhile, nobody yet knows how great the drop in tax receipts is going to be during this and the next fiscal year, but judging from the corporate statements coming out now, judging from the prospective cave-in in capital gains receipts scheduled for 1970, and the squeeze on individual income taken together with the rising unemployment, the budget deficits coming up could make U.S. financial history.

So far, the Administration "game plan" is for a mild recovery or neutral pattern during 1970 with a definite recovery scheduled for 1971 and 1972. But as economist Eliot Janeway noted in his latest report, "1970's fade-out surprise in the economy is coming as the biggest surprise in a year of surprises." Janeway then comes to a thesis which I have been harping on for quite some time. The slowdown in business, rather than improving corporate liquidity, is actually making it worse. Far from being the "normal" correction which is associated with recessions and pseudo-recessions, this late-1970 slump is pressing corporations to the edge of insolvency. The panic point is being reached by many businesses as their costs rocket and as their sales stagnate.

I agree with Janeway in that 1971 may see a short and rapid business pickup brought on by a spurt of buying as the GM strike ends, but neither a rise in corporate profits nor increased corporate liquidity is in the cards, and this is going to be the fooler. The second fooler, I feel, will be a continuation of the slump,





 and a deepening of the slump during 1971 and into 1972. But what I don't know, and what I wouldn't even want to hazard a guess on, is what is going to happen as corporation after corporation sees their profits all but vanish in the face of high costs, declining business volume, and mass uncertainty regarding the business outlook.

As I have written many times before, it is one thing going through a recession while you are plumped with cash and in a highly liquid state. It is another thing going through an extended downturn while your debt is eating you alive, your costs are sky-high, and your sales volume and cash flow is declining.

Meanwhile, the attitude of the consumer is anything but heartening. Business Week magazine, last week, presented an article regarding hard times for the posh, carriage-trade restaurants in New York and across the country. The big spenders are not spending any longer, and I sense that the American consumer (who ultimately always comes to his senses) is beginning to wonder what it is all about. For while our generation is loaded with mortgages, debt, cars, boats, taxes, two and three TV sets, swimming pools, and a thousand other high-ticket items, our kids are running around in blue jeans and T-shirts and telling us our whole way of life is "for the birds". And I can't prove it, but I have a sneaking suspicion that a little of what the kids are saying is beginning to rub off.

After all, if department heads at GM can wear mustaches and beards, if what's left of the brokers can sport mutton-chop sideburns and Van Dyke beards, who can say that what the new generation thinks and does will not have an effect. The American people have been chasing happiness via chrome and swimming pools for thirty years now, and I haven't noticed that they are any happier than they were when the national debt was one-third of what it is today. So I'm wondering what's in store for us as this bear market works its way towards its inevitable conclusion. Personally, I've prepared my mind for some drastic changes coming up over the next two or three years, changes in living habits and thinking which I feel would be considered almost impossible today.

Meanwhile, the stock market continues to follow its corrective or counter-primary trend action, in an advance which can be likened to a "vacation" from the basic bearish tide. Starting from the May 25 low of 631.16, the Dow forged ahead to close at a recovery peak (October 7) of 783.68.

Since the peak, the Dow has dropped as low as 753.56 (October 29), but the action of the market as a whole has been considerably poorer than what is reflected in the Dow (see next section). Despite the renewed strength which began on election day, the Industrial Average continues to rush up and drift back within the 750-780 range, with the Transportation Average (which lost twice as much as the Dow in percentages during the October decline) now lagging on the upside. No small part of the Transportation performance has been the fact that the first six months of 1970 provided the airlines with their worst overall losses in history.

Finally, I would like to touch on one aspect of the market, which for some unknown reason, no one has mentioned. There seems to be a widespread agreement on the "fact" that as soon as the GM strike is settled, the market will roar skyward. But I want to remind subscribers that the market's function is to discount. Now it is absolutely certain that the GM strike must ultimately be settled. It may be settled in a week or a month or two months. But it will be settled. It seem entirely possible to me that the market has already discounted the news of the settlement. Therefore, it would not surprise me to see the market sell off on the actual news that the strike has come to an end (it may take a few days of churning to do this).

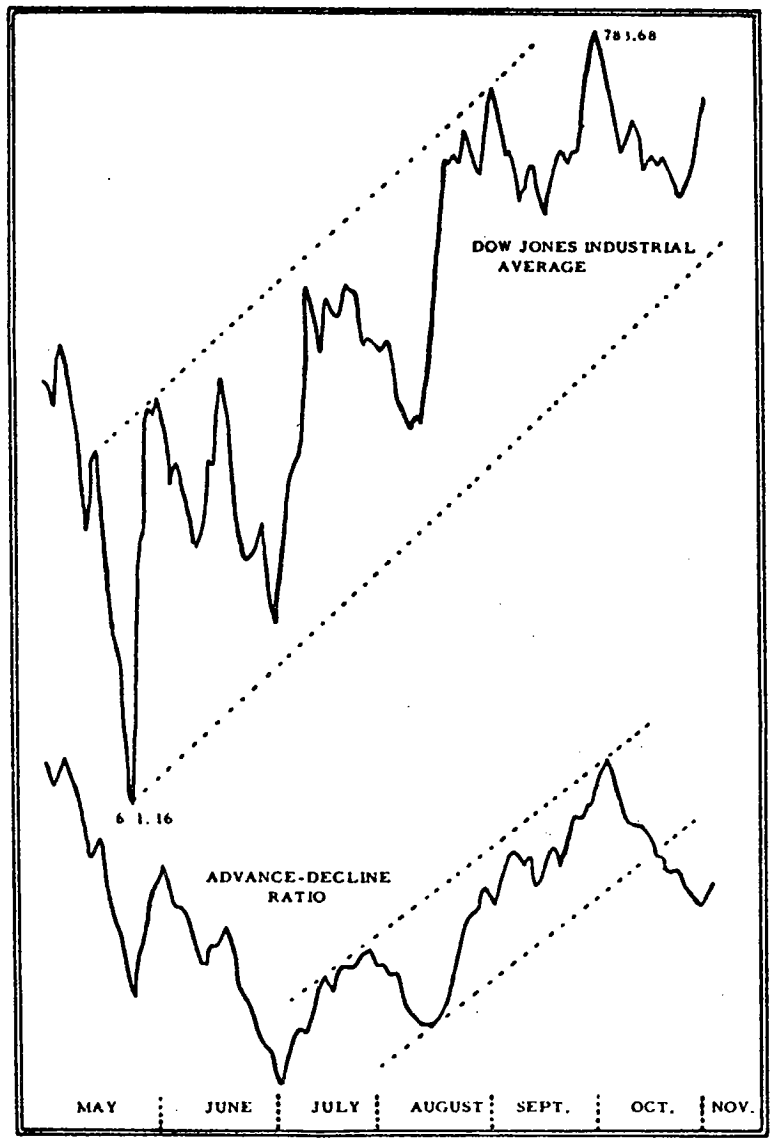
I am reminded of the great steel strike of late-1959, and the consensus at that time that as soon as the steel strike was settled, the market would head for 1000. The strike was settled in early January, the market churned for a few days, and then headed down into a violent break which left many confused and amazed. The action was obvious enough, and it was logical enough. The pre-settlement level of the market was the level which was already discounting an end to the strike. When the news of settlement broke, the market broke too as thousands of informed traders rushed to unload on the good news.

It might be different this time, but I would never bet on the market celebrating a predictable event in a way that pleases all the "waiters". Rather, I would be more inclined to think that the current price level already has discounted the very predictable fact that GM and the union must and will settle. It is merely a matter of when, and those who are preparing for a giant rise after the publication of the news could be in for a rather shocking time.

ADVANCE-DECLINE RATIO (BREADTH): On October 22, for the first time in several months, daily new lows on the N.Y.S.E. outnumbered new highs. The tally on October 22 was 6 new highs, 12 new lows. By October 30 the tally was 15 daily highs, 27 daily lows. The 27 lows was the highest figure since August 13.

The slowly increasing roster on the new low list is a reflection of the steady deterioration of breadth which has been going on ever since the October 7 market peak. Note on the page 3 chart that while the Dow Industrials have been perched hopefully in the 747 to 783 area for the past two months, the A-D ratio has been sliding. By October 30 the A-D ratio had declined to its August 27 level, having wiped out all the September and early-October gains.

The current position of the two indicators sets up a possibility which has often been seen in the past when breadth suffered severe deterioration in the face of an Industrial Average which apparently "did not want to go down". I would guess at this time that the A-D ratio (and therefore the majority of issues on the N.Y.S.E.) have seen their highs for this move and probably for a long time to come. I doubt that any forthcoming advance would have the persistence or strength to take the A-D ratio above its early-October peak. Therefore, we could well get one more (distributive) run-up on the Dow, accompanied by sluggishness in the A-D ratio, before the market heads down again in earnest. In fact, it would not be surprising to see the Dow rally to a new high above the October 7 peak of 783.68.



But such a rally would in all likelihood represent the final "passing out of shares" preparatory to broad weakness and new lows all around during 1971. In other words, I feel that the Dow and the A-D ratio have now gotten out-of-gear. The A-D ratio has sustained so much damage that to all extent and purposes we can say that the majority of issues on the N.Y.S.E. have started on a subtle downtrend which will pick up in violence and intensity once the Dow Industrial Average decides to break down and plunge in earnest. Such a breakdown, however, could well require one or more non-confirmations on the upside before it begins.

THE CONFIDENCE INDEX (C.I.): In the last Letter I showed a chart of the C.I. along with two major bond averages. As subscribers know, the C.I. is based on the ratio of the yields of medium-grade and high-grade bonds. Sophisticated bond buyers, in times of uncertainty, tend to move into the safety of the highest-rated bonds (even though they have lower yields), and at such times the C.I. reflects the changing yield ratio by declining. Since bond buyers and traders tend to be rather knowledgeable regarding credit and finance, the movements of the C.I. tend to precede movements in the stock market. The time-honored lead time runs around two to four months.

I have included two charts (page 4), one showing the weekly D-J Industrial action, the lower one showing the weekly C.I. figures. The Dow has been superimposed to provide a lead time of four months (charts courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y. 10514). I have drawn three trendlines on the C.I. chart. In broad terms, the declining trend from A to B reflects declining confidence in bonds during January to October, 1969. Note that A on the C.I. preceded point A on the Dow by over six months. Note also that B on the C.I. preceded B on the Dow by around six months.

The rise in confidence from B to C was later reflected by the rally in the Dow from the 631.16 low closing of May 26 to the recent October 7 peak of 783.68. Now we come to the latest broad movement in the C.I. which I show as the decline from C to D. This decline in confidence, I feel, should reflect itself in the Dow over coming months.

An important point to note is that the broad movements in the C.I. have, over the past few years, started as much as six months before movements in the stock market. This is a much longer lead time than usual. If this lead time holds, we might expect the next major decline in the Dow to come about six months after the beginning of the last major decline in the C.I. The C to D decline in the C.I. began in early June, indicating that a major drop in the stock market could start anytime between now and early December.

Idle Capacity Up; Use in 3d Quarter Dropped to 76.2%

Special to The New York Times

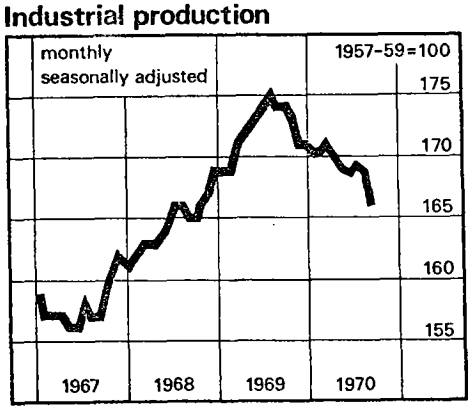
WASHINGTON, Oct. 26—Idle capacity in manufacturing increased further in the third quarter of this year, the Federal Reserve Board reported today.

The board's measure of "capacity utilization" dropped to 76.2 per cent, compared with 78 per cent in the second quarter and 84.2 per cent in the third quarter last year.

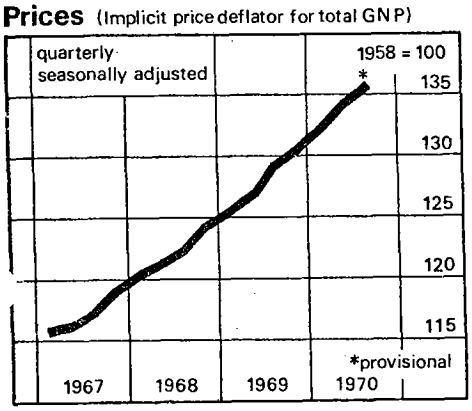
The figure for the July-September period was the lowest since the first quarter of 1961, when the economy was in a recession.

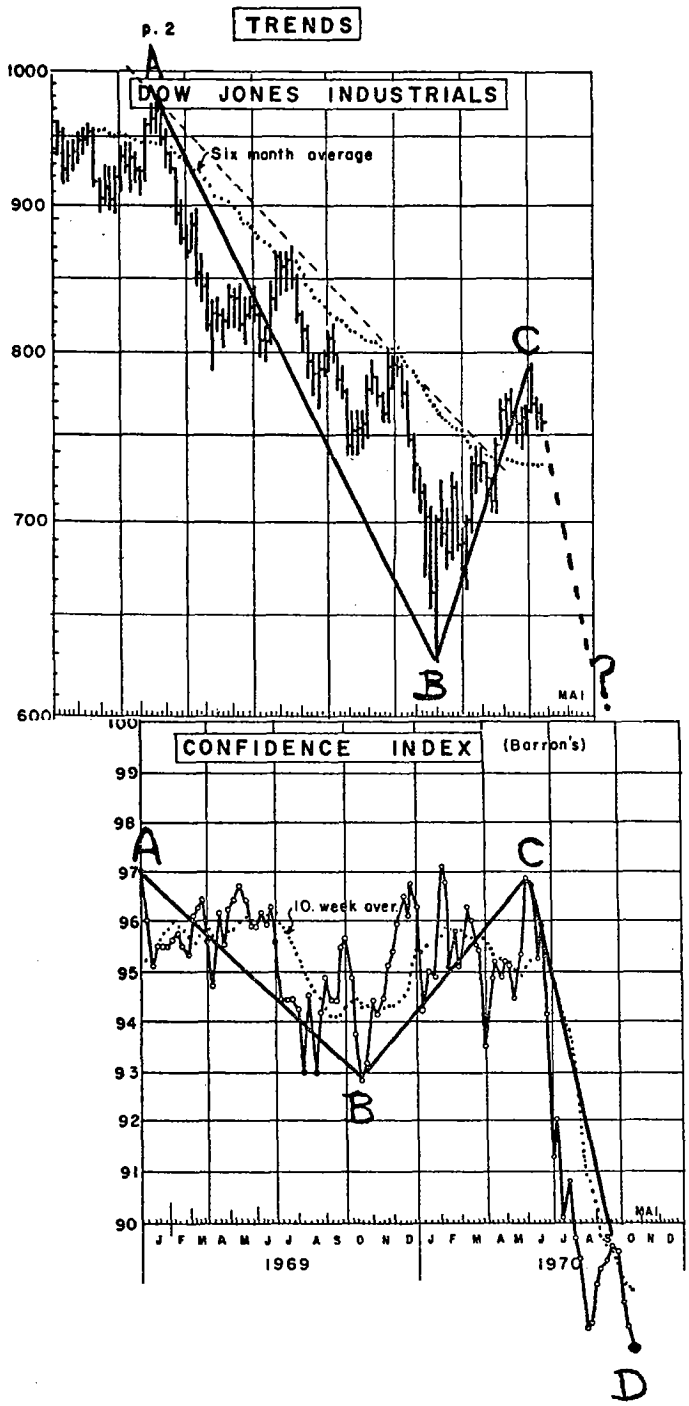
Manufacturing output has been drifting gently downward since mid-1969, while capacity has continued to grow. The result has been a big rise in idle capacity.

Industrial production



Prices (Implicit price deflator for total GNP)

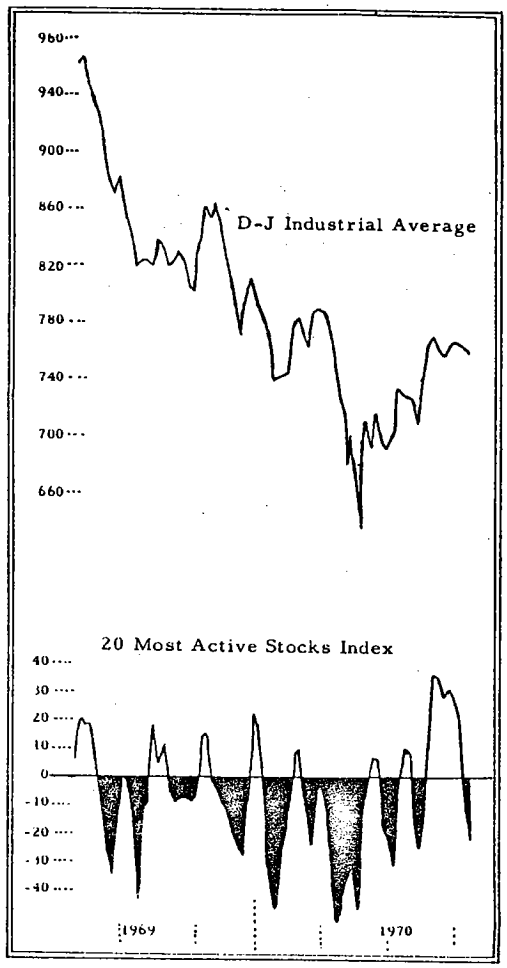




NEWS CLIP OF THE WEEK: Note that the nine-year low in idle plant capacity came prior to the GM strike. It coincides with the collapse of new tool orders, and it means that far from needing to expand, American industry is now saddled with a great deal of unused plant and equipment. The nation, far from needing a capital goods boom, now needs a buying boom, and I don't think that's in the cards.

CHART OF THE WEEK: Needing little comment, this rather shocking chart was printed in the October 24 issue of the London Economist. I would guess that ultimately, one graph or the other is heading for a change in direction.

20-MOST ACTIVE STOCKS: I mentioned this Index in the last Letter, and Alan Abelson quoted from its originator in the October 26 issue of Barron's. I am including a chart (page 4) of the Index (published in Barron's during mid-1969) which shows the Index going back to 1965. I am also publishing my own chart which brings the Index up to date.

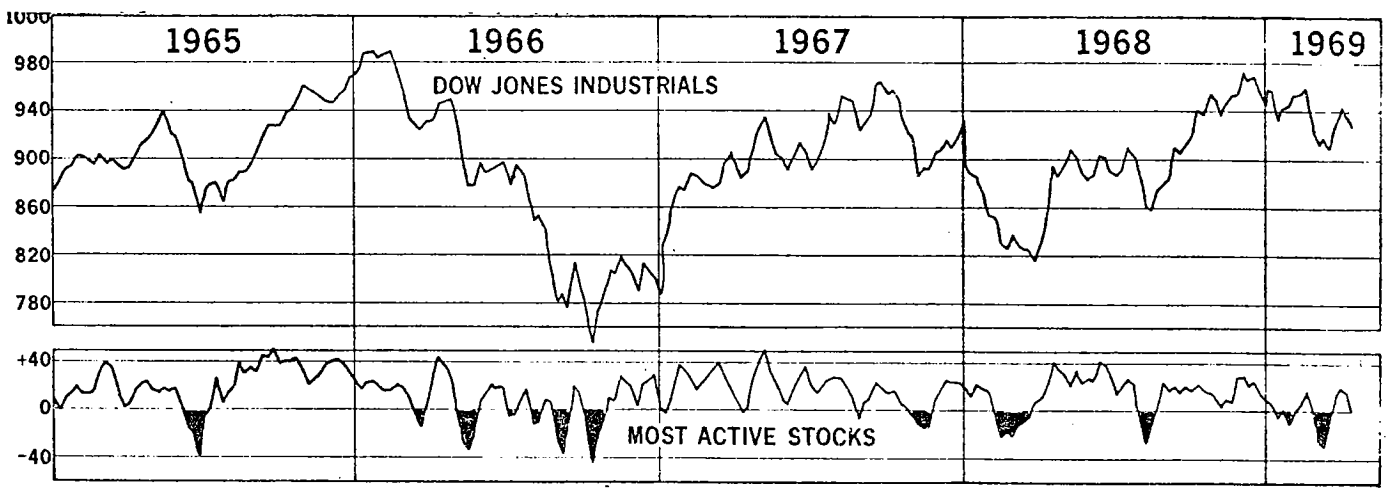


The composition of the 20-Most Active Stocks Index is simple enough. Each week Barron's publishes the 20 most active stocks on the N.Y.S.E. for the preceding week. The plurality of advances or declines is then computed, and these figures are arranged in the form of a 3-week moving average. These 3-week averages are what comprises the Index. For instance, if on a single week 6 stocks advanced and 14 declined, the index figure would be minus 8. That figure and the pluralities for the two preceding weeks would make up the latest figure for the Index.

The rationale for the Index is logical enough. During any week the 20-most active stocks make up about 15% of total volume. Any 20 stocks which can bring in roughly 15% of the entire volume on the N.Y.S.E. must be important vehicles, and the overall direction of these 20 stocks tends to lead the direction of the general market.

As seen on the chart, the year 1969 was the worst year for the Index since the bear market began in February, 1966. As a matter of fact, 1969 was the worst year for the Index since the 1930's. So far in 1970, the record has not been much better. Of the 44 weeks which have elapsed so far in 1970, only 16 have shown pluses on the Index. This means that the 20-most active leadership has been on the downside about two-thirds of the time.

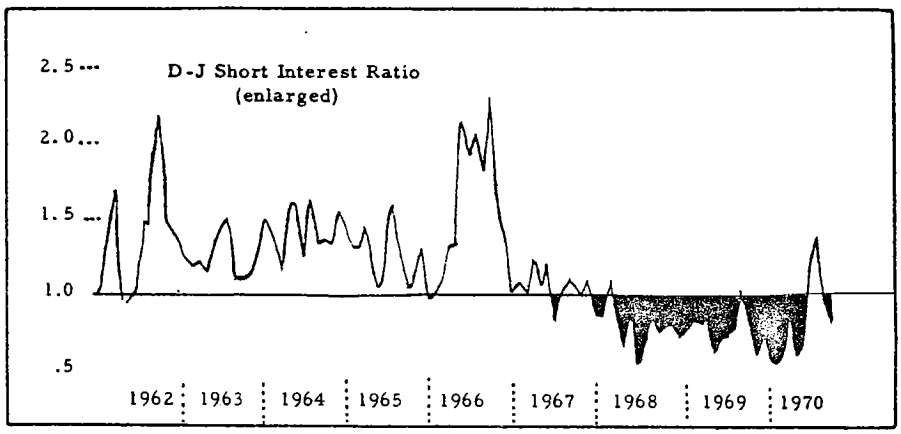
The high-spot on the Index came on September 3, a week which saw the Index at plus 36. But as noted in the Abelson column, this came 15 weeks after the Dow Industrial bottom, and as such it must go down as a "tired" and belated performance. Six weeks after the September 3 peak, the Index went negative again (compare that performance with the one in 1967), with the 20-most active Index actually looking much worse than the Dow.



CONCLUSION: The 20-Most Active Index tends to reflect the direction of big trading and investing money. A trend in this Index generally precedes a trend in the general market. The performance of the Index from the May low to the September high was sub-standard in terms of real bull market action, but typical of a bear market rally. After trending up since the April low of minus 50, the Index appears to have topped out at the September 3 peak of plus 36.

Declining trends in this Index (descending peaks and bottoms) can last as long as a year. My guess is that the Index reversed to the downside on September 3, and that by mid-1971 we will see another "oversold" figure in the minus 40 to minus 50 range — together with much lower prices on the N.Y.S.E.

DOW SHORT INTEREST: In Letter 475 I reviewed the history of the Dow Short Interest Ratio with a chart going back to 1931. I just received the latest (September-October) tabulations from Bill Gordon in New York, and these show a 15% drop in the short interest in the 30 Dow stocks from 915 thousand to 762 thousand. With higher average volume in these same 30 stocks the Dow short interest ratio dropped to .80 for the latest figure, down from .96 for September.



As readers know, I consider anything above 1.5 on the D.S.I.R. as mildly bullish and anything above 2.0 as very bullish. Almost all the major advances since 1931 have started from a figure on the D.S.I.R. of at least 2.0. I consider 1.0 to 1.5 as neutral on the D.S.I.R. and anything below 1.0 as bearish.

As seen on this nine-year chart, the high on the D.S.I.R. for 1970 was the August figure of 1.40. I wrote at that time that this was not an impressive figure, and certainly not one associated with a major advance or a reversal in the primary trend. The September tabulation dropped to .96 and the latest tabulation, which is deep in bearish territory again, is .80.

Since January, 1968, the D.S.I.R. has set an unmatched (for bearishness) record of being below 1.0 on 31 of the past 34 months. Only the months of September, 1969, July, 1970 and August, 1970 were able to show readings above 1.0. This amazing performance underscores what I wrote in the last Letter regarding persistent bullish enthusiasm during this primary bear market.

For if people were bearish, truly bearish, we would have readings of 2.0 on the D.S.I.R. which means perhaps double the current number of shorts in the 30 Dow stocks (assuming that volume stays the same). So again, the D.S.I.R. is saying "danger", and I will again remind subscribers that this Index has had a remarkably good record of calling the shots over the past 40 years.

STOCKS: The recent rally in the gold stocks to new highs for 1970 carried particular significance as far as I was concerned. Here is why: The recent rallies took two of the three listed N.Y.S.E. gold issues above the halfway point of their entire 1969-70 declines. Here, the 50% rule can be applied. When, following a major decline, a stock can rally and better the halfway level of that decline, there is a strong probability that the major trend of that stock has turned bullish, and the stock may be expected to test or better the old highs.

The 1969-70 drop for Campbell Red Lake carried from 47 1/4 to 15 3/8. The halfway level of the decline was 31 3/8. In late-October Campbell rose to 34 3/8 before correcting, but the 34 3/8 level was well above the 31 3/8 halfway point. Conclusion: Campbell could well be on its way to the old high of 47 again.

Dome dropped from 89 to 45 during 1969-70, with a halfway point of 67. On the late-October rally Dome touched 67 3/4, just above the halfway point.

Homestake was the only failure, but I feel it will be carried along by the others. The 1969-70 drop in HM was from 46 1/2 to 16 1/8 with a halfway level of 31 3/8. The 1970 high for HM was 27 7/8, 3 points short of the halfway mark.